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BEFORE THE

Federal Communications Commission

WASHINGTON, D.C.

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992 **Rate Regulation**	)	**MM Docket No. 93-215**

To: The Commission

REPLY COMMENTS OF TIME WARNER ENTERTAINMENT COMPANY, L.P.

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SUMMARY

The myriad of proposals and positions in the record reflect the intricacy and complexity of the issues involved. These matters cannot be resolved in this one proceeding. Instead, the record demonstrates that the adoption of Time Warner's ad hoc approach is the only sensible option for the Commission.

Consistent with Time Warner's case-by-case approach, the Commission should reject the comments of those parties that would saddle the entire cable industry with industry-wide requirements when only a select group of operators will need to submit a cost of service showing. Therefore, the Commission should refrain from adopting a Uniform System of Accounts, cost allocation and cost accounting rules, depreciation schedules, and rates-of-return.

Similarly, the Commission should reject proposals to establish "regulatory parity" between the telephone and cable industries. Not only did the Commission previously reject this concept, but it would contravene the Cable Act, which states that cable systems "shall not be subject to regulation as a common carrier or utility by reason of providing cable service." 47 U.S.C. § 541(c).

In addition, there is no basis on this record to conclude that a productivity offset is warranted for the cable industry. As explained in the attached paper by Daniel Kelley and Robert Mercer of Hatfield Associates, Inc., no quantitative evidence is provided in the record that shows that the rate of productivity

change in the cable industry has exceeded the rate in the economy generally. Furthermore, it would be rough justice for the Commission to adopt in this one rulemaking a productivity offset when it took the Commission several years, numerous studies, and a voluminous record to conclude that a productivity offset should be applied to the telephone industry.

Finally, the Commission should reject proposals to establish threshold tests for cost of service showings. The adoption of a confiscatory or bankruptcy standard would nullify the use of cost of service regulation as a backstop.

Repeatedly, the Commission has assured that cable operators will be able to demonstrate that their unique costs warrant special treatment. Time Warner urges the Commission not to adopt rules or regulations that would undermine or threaten this objective.

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To: The Commission

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Time Warner Entertainment Company, L.P. ("Time Warner"), by its attorneys, hereby submits its reply comments in response to the Commission's July 16, 1993 Notice of Proposed Rulemaking concerning "cost of service" regulation of cable television prices.[1]

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[1] These reply comments are submitted without prejudice to Time Warner's continuing contention that the price regulation provisions of the 1992 Cable Act are unconstitutional. Time Warner's contentions in this regard are now pending before the United States District Court for the District of Columbia in Time Warner Entertainment Co. v. FCC, No. 92-2494 (TPJ).

I. CABLE OPERATORS MAKING COST OF SERVICE SHOWINGS SHOULD BE ABLE TO PROCEED ON A CASE-BY-CASE BASIS USING GENERAL GUIDELINES

The comments in this record demonstrate the complicated nature of this proceeding. Even among cable operators there is no consensus on how to resolve the difficult issues raised in the Notice. Local franchising authorities and their representatives, as well as telephone companies and pro-consumer groups also present varying and differing views. No doubt this is a result of the intricacy and complexity of the issues. The matters addressed in the Notice cannot be resolved in this one proceeding and the Commission should not even attempt to do so. Rather, the ad hoc approach advocated by Time Warner and others[2] should be adopted by the Commission as it is the only realistic option available.

The objective of this proceeding should be to provide a fair and efficient way for individual cable operators to demonstrate, in specific circumstances, that prices above benchmark levels are justified. This can be achieved without having to undergo the rigorous requirements necessary for a full cost of service hearing. Where cable operators can present evidence demonstrating that their costs exceed benchmark rates other than through a traditional cost of service showing, these abbreviated showings should be encouraged.[3] Creating a flexible

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[2] See the Comments of the Connecticut Department of Public Utility Commission, NCTA, and TCI in this proceeding.

[3] See Medium Sized Operators Group at 10, Cablevision Industries at 34, and Cable Operators and Associations at 97.

regulatory structure for the backstop mechanism that avoids the well-known shortcomings of traditional public utility regulation while still providing sufficient protection to cable customers and operators should be the Commission's overarching goal in this proceeding.[4]

As Dr. Schankerman notes in his attachment to GTE's comments, unless the benchmarks incorporate "a more complete list of 'cost determining' characteristics," cable operators will need to resort to cost of service showings. Such a result will needlessly "destroy both efficiency incentives and administrative simplicity."[5]

In keeping with the "backstop" nature of cost of service regulation, only general guidelines should be adopted for cost-based showings. As a threshold matter, all reasonable expenses associated with the provision of regulated cable service should be recoverable.[6] Additionally, the Commission should

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[4] See California Cable Television Association at 37, Media General Cable of Fairfax County at 4, Medium Sized Operators Group at 26, and Cable Operators and Associations at 96. Repeatedly, in defending the use of broadly averaged benchmarks, the Commission has reaffirmed its view that cost of service regulation will afford individual cable operators an opportunity to demonstrate that their costs exceed benchmark rates. First Order on Reconsideration at ¶¶ 13, 14, 36, 97, 118, and. 180.

[5] Dr. Mark Schankerman, GTE Attachment at 7.

[6] See, e.g., Medium Sized Operators Group at 3, BellSouth at 10, and Cable Operators and Associations at 98.

allow a return on all capital invested in assets associated with the provision of regulated cable service.[7]

The Commission should also not be persuaded by arguments, such as that advanced by the New Jersey Board of Regulatory Commissioners, that all excess acquisition costs "may represent expectations of monopoly rents." See New Jersey Board of Regulatory Commissioners at 7. No one could reasonably contend that all of the "excess" is due to expected monopoly rents. Cable companies have had numerous valid and publicly beneficial reasons for making acquisitions. For example, the practice of "clustering," whereby cable operators acquire neighboring systems in order to achieve operating efficiencies that would otherwise not exist, may yield an acquisition price that reflects these expected efficiencies. There is no reason to deny an operator a return on an efficiency-enhancing investment. In fact, if the Commission were to deny a return, it would create disincentives for cable operators to engage in transactions that benefit subscribers.

Moreover, the Commission should not set up a presumption that all "excess" acquisition costs are excludable let alone attempt summarily to exclude them. Disallowance on an a priori basis of costs that were lawful when incurred would raise substantial constitutional issues.[8]

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[7] See Tele-Media at 15.

[8] See California Cable Television Association at 41, Medium Sized Operators Group at 18, Cablevision Industries at 22, and Viacom at 21.

Similarly, accumulated losses should be included in the capital on which a return is allowed. As the record in this proceeding makes clear, early start-up losses are common throughout the industry. These start-up losses are recouped only as the system matures and, therefore, should be given ratebase treatment.[9]

A case-by-case approach should likewise be adopted for rates-of-return. A single, uniform industry-wide rate of return, while arguably appropriate for telephone companies, is not appropriate here. Not only are there large differences between the cable industry and the telephone industry, but cable companies widely differ among themselves in terms of financial structure and overall financial strength. These differences make it impossible to adopt a single rate-of-return that fairly reflects the cost-of-capital for a particular system electing to submit a cost of service showing.[10]

Additionally, uniform accounting rules or practices should not be mandated for the entire cable industry.[11] Given that only a minority of cable systems will elect cost of service regulation, it would be patently unfair and illogical to require

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[9] See Summit Communications at 5, Tele-Media Corporation at 15, and Cablevision Industries at 24.

[10] See Avenue TV Cable Service at 5, Tele-Media Corporation at 16, Medium Sized Operators Group at 47, and Cablevision Systems at 34.

[11] See Media General Cable of Fairfax County at 12, Medium Sized Operators Group at 22, Viacom at 51, and Cablevision Systems at 37.

the entire industry to shoulder the burden of changing its accounting practices.[12] Similarly, the Commission should not prescribe depreciation rates at this time.[13] Rather, the Commission should adopt a general policy of accepting the rates and practices currently used by a particular system, which the Commission has already required to be consistent with Generally Accepted Accounting Principles.

The ad hoc approach advocated by Time Warner is supported by several state regulatory bodies. The Connecticut Department of Public Utility Control (CDPUC) would grant "wide latitude" to cable operators in submitting cost of service showing. CDPUC Comments at 1. Furthermore, CDPUC acknowledges that rates-of-return and depreciation schedules cannot and should not be prescribed in this proceeding. Id. at 2-3. Similarly, the New York State Commission on Cable Television notes that because of the complexities and burdens associated with cost of service regulation, the Commission "should pursue with the utmost diligence" streamlining alternatives. New York State Commission on Cable Television at 2. That two state commissions recognize the obvious benefits to regulators, consumers, and cable operators of a case-by-case approach is especially noteworthy.

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[12] See Medium Sized Operators Group at 23, and Viacom at 51. The rules in Sections 76.924(f) and (g) provide sufficient guidance for allocating common costs.

[13] See Tele-Media Corporation at 10, Media General Cable of Fairfax County at 11, Medium Sized Operators Group at 22, and Cablevision Systems at 35.

In sum, there are several principles that should guide the Commission in this proceeding. First, cable operators electing the benchmark approach should not be burdened with traditional cost of service requirements. That means that systems regulated by the benchmark scheme should not be required, for example, to adopt accounting methods such as a USOA or cost allocation rules, depreciation schedules, performance measures, etc. To require compliance with such rules would only impose significant costs on cable operators and their subscribers for no reason.

Second, individualized showings should be encouraged. Industry-wide averages are not consistent with the purpose of the backstop function of cost of service regulation. By definition, those systems submitting cost of service showings will be outside the average.

Third, the Commission should not issue an FCC-prescribed form for cost showings. This would only restrict or limit the ability of cable operators to make cost-based presentations. The Commission simply is not in a position at this time, given its lack of knowledge about and experience with the cable industry, to define and prescribe forms for cost-based presentations.

Although traditional cost of service regulation is known to be inherently inefficient, Time Warner is not suggesting that cable operators should be prevented from undertaking a complete cost of service hearing if they desire, but only that alternative regulatory approaches should be explored and encouraged. One streamlined alternative to traditional cost of service regulation would permit showings in support of upward adjustments to the benchmark prices to reflect particular high-cost conditions faced by a given system. Where this showing can be made -- for example, by recalculating the regressions underlying the FCC benchmarks to provide a reasonable benchmark figure, or by showing that the cable system faces above-average costs of a particular kind -- the adjustment to prices should be permitted without undertaking a full scale analysis of all of the system's costs. Over time, the Commission may accumulate sufficient information further to abbreviate or routinize such showings. But until then, the Commission has no choice but to proceed on an ad hoc basis.

II. THE COMMISSION SHOULD DISMISS PROPOSALS OF "REGULATORY PARITY" BETWEEN THE TELEPHONE AND CABLE INDUSTRIES

The joint pleading filed by NYNEX, Bell Atlantic and the Pacific Companies ("Joint Parties") claims that "the Commission's guiding principal in this proceeding should be regulatory parity between the rapidly converging and increasingly competitive cable and telephone industries."[14] The Joint Parties argue vigorously for identical rules for both the telephone and cable industries with respect to accounting measures, cost allocation, sharing obligations, productivity offsets, ratebase

[14] Joint Parties Comments at 1. The attached paper by Daniel Kelley and Robert Mercer, "Regulatory Parity and Public Policy," discusses the joint filing in detail.

and expense treatment, and rates-of-return. For the reasons discussed below, Time Warner urges the Commission to reject the Joint Parties' pleading.

By statutory directive, Congress rejected the Joint Parties' claim that regulatory parity should be established between the cable and telephone industries: "Any cable system shall not be subject to regulation as a common carrier or utility by reason of providing cable service." 47 U.S.C. § 541(c). In addition, in the First Order on Reconsideration, the Commission concluded that:

> [t]elephone companies have failed to advance a sufficient reason why we should adopt as an overriding policy goal achieving parity in price cap mechanisms for the two industries. Instead, our price cap requirements for cable and telephone services are, and should be, based on the respective, separate considerations discussed in the proceedings in which we adopted those respective requirements.[15]

The Commission should reconfirm its position that regulatory parity is not only undesirable, but is an inappropriate objective for cable rate regulation. Oddly enough, the Joint Parties even concede that the rules they propose are bad public policy:

> We believe that many of the rules that currently apply to telephone companies are outmoded and should be streamlined or eliminated. Nonetheless, so long as the Commission believes that it must pervasively regulate telephone companies, these considerations, reinforced by the Congressional policy underlying the 1992 Cable Act, support the adoption of rules for

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[15] First Order on Reconsideration at ¶ 90 (footnote omitted).

> cable that closely resemble the rules for telephone companies.[16]

In addition to the Commission's rejection of this objective and the Joint Parties' own submission that the requirements of traditional cost of service regulation are "outmoded," there are other clear differences between the cable industry and the telephone industry that run counter to the contrivance of regulatory parity.

The primary method of rate regulation for the majority of cable operators is the newly-introduced benchmark system, which is not based on costs. The opportunity afforded cable operators to elect cost of service showings is intended only as a backstop for the atypical, high cost cable operator. Therefore, only those operators that elect cost of service showings will need to justify their costs.

By contrast, cost of service regulation has been the primary form of regulation for the telephone industry as a whole, and has been in place for decades. By definition, telephone rates were developed based on costs, and universal adherence to uniform conventions was required because all telcos were subject to the rules; no alternative regulatory schemes existed. Cost accounting rules and a prescribed USOA were necessary features of a regulatory regime solely based on costs.

Due to this basic distinction between the use of cost of service regulation for telcos and cable companies, any

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[16] Joint Parties at 2.

proposal that would saddle all cable operators with burdensome cost of service rules is wasteful, administratively burdensome, and unnecessary. Most operators will be regulated under the benchmark system. Therefore, the Commission should reject the Joint Parties suggestion to adopt parallel cost accounting, financial reporting, and other similar requirements when only a select number of cable systems will submit cost of service showings.

III. THERE IS NO BASIS FOR CONCLUDING ON THIS RECORD THAT A PRODUCTIVITY OFFSET IS WARRANTED

The Joint Parties claim that the same productivity offset applied to the telcos should equally apply to the cable industry, but they provide no quantitative analysis or other evidence of productivity changes in the cable industry.[17] The attached paper by Daniel Kelley and Robert Mercer ("Kelley and Mercer") of Hatfield Associates, Inc. provides substantial evidence that there is "little similarity between cable systems and LEC networks that would provide grounds for the naive assumption that productivity in cable systems and telephone

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[17] Nor do they justify the time or expense associated with a related proceeding. For example, the Commission issued four notices, two orders and one reconsideration order in prescribing productivity offsets for AT&T and the LECs. See Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Notice of Proposed Rulemaking, 2 FCC Rcd 5208 (1987); Further Notice of Proposed Rulemaking, 3 FCC Rcd 3195 (1988); Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873 (1989); Supplemental Notice of Proposed Rulemaking, 5 FCC Rcd 2176 (1990); Second Report and Order, 5 FCC Rcd 6786 (1990); Order on Reconsideration, 6 FCC Rcd 2637 (1991).

networks should bear any relationship to one another." Kelley and Mercer at 14.

As Kelley and Mercer show, the Joint Parties not only misapprehend the regulatory scheme adopted by the Commission, but also the technology used in the cable systems and the relationship between this technology and cable system productivity. An understanding of these concepts leads to the conclusion that a productivity offset for the cable industry is not warranted; most certainly not on the basis of this record.

First, although the Joint Parties discuss technological changes that could lead to increased productivity, they do so only in a descriptive way. No quantitative analysis is provided to support their contention. Moreover, the Joint Parties fail to address the most relevant issue, that is, "whether the rate of productivity change has exceeded the rate in the economy generally, and if so, by exactly how much." Kelley and Mercer at 5 (footnote omitted).

The changes identified by the Joint Parties do not necessarily result in increased productivity. For example, the claim that "[i]ncreases in subscribers entail relatively few additional costs," ignores the fact that there are significant costs incurred in adding new subscribers, such as marketing expenses, as well as programming, plant expansion, billing for service, etc. Kelley and Mercer at 5. Similarly, the deployment of fiber optics and the development of digital technology will produce many benefits but it will not necessarily result in predictable changes in productivity.[18]

Second, it is impossible to predict future productivity gains based on historical productivity levels. During the past decade, the cable industry has experienced dramatic growth. As a result, one would expect gains in productivity to occur. But as Kelley and Mercer demonstrate, as the industry matures and stabilizes, these "productivity increases become harder to sustain." Kelley and Mercer at 7. In fact, given that cable systems now pass 96% of the homes and that alternatives to cable service exist, future productivity increases may be on the decline.[19]

Finally, the Joint Parties have failed to provide any correlation between cable system and local telephone company productivity, or between other respective changes in their productivity. As Kelley and Mercer describe in detail, "the services, architecture, technology, and operation of cable systems and LECs are so different as to render any such comparison meaningless." Kelley and Mercer at 9.

> Today's cable systems primarily deliver a broadband video broadcast service, using a tree and branch architecture and a non-switched headend. LEC networks support a

[18] Kelley and Mercer identify other fallacies with the Joint Parties claim that the cable industry has been experiencing increased productivity. See Kelley and Mercer at 5-6.

[19] Regulation has also been known to have a negative effect on productivity. See John Duke, Diane Litz, and Lisa Usher, "Multifactor productivity in railroad transportation," Monthly Labor Rev. (August 1992)

> variety of analog and digital narrowband services using a star architecture, copper wire as the primary transmission medium, and switching in the central office. Such evident differences extend into the details of equipment utilized, deployment and operation of the equipment, and the like.

Kelley and Mercer at 14.[20]

While it may be true that the local exchange networks and cable systems are converging towards greater commonality, they are indeed different. In any event, there is no reason to assume that the productivity changes should be the same for the two. Rather, as Kelley and Mercer point out "[t]he two would be converging to the same end from dramatically different starting points. Therefore, the productivity changes would likely be quite different." Kelley and Mercer at 15. And, even if convergence were eventually to exhibit similar productivity changes, that convergence is not likely to happen over the relevant time period.

IV. THE COMMISSION SHOULD NOT ADOPT THRESHOLD TESTS FOR COST OF SERVICE SHOWINGS

Several commenters have proposed unnecessary hurdles for cable operators before a cost of service showing can be made or before a particular cost factor will be included. Time Warner opposes the adoption of these proposals because they contradict the Commission's intention to use cost of service as a "backstop" to the benchmark system of rate regulation.

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[20] For a more comprehensive discussion of these differences, see Kelley and Mercer at 9-15.

For example, NATOA proposes that cost of service showings should only be allowed if the cable operators can demonstrate that the rates calculated under the benchmark are "confiscatory because the operators have special circumstances that result in extraordinarily high, justifiable costs."[21] The Consumer Federation of America (CFA) proposes to disallow the recovery of excess acquisition costs absent a showing of avoidance of financial bankruptcy of the system.[22]

Adopting any "confiscatory" or "bankruptcy" standards would nullify the use of the cost of service showing as a backstop. In fact, the requirement that a cable operator demonstrate "special circumstances" before being able to proceed with a cost of service showing is inconsistent with the Commission's repeated assurance that cable operators will be able to demonstrate, if necessary, that their costs exceed benchmark rates.[23] More importantly, the Commission in the Rate Order rejected the approaches urged by NATOA and CFA. As explained in the Rate Order:

> The Commission [will] embody in [the cost of service] standards a balancing of the interests of consumers in paying a reasonable rate and of cable operator's ensuring a reasonable profit. A "confiscatory only" standard would, by contrast, . . . ultimately disserve consumers by liming cable operators' business incentives to provide service.

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21 NATOA Comments at 3.

22 CFA Comments at 4.

23 See note 4, supra.

Rate Order at ¶ 263. CFA and NATOA's attempt to raise an issue that properly belonged in a petition for reconsideration of the Rate Order should be rejected.

One of the principal goals of the Cable Act is to ensure the continued growth of cable. Plainly, an extreme policy of requiring that rates actually be confiscatory before they can be deemed unreasonable is at odds with Congress' purposes. Accordingly, cable operators should be free to elect a cost of service showing based upon their individual circumstances.

CONCLUSION

Time Warner urges the Commission to adopt the ad hoc approach discussed herein as it will afford cable operators, consistent with the Commission's repeated assurances, the best opportunity to show that its costs exceed benchmark rates. Furthermore, there is no basis on this record to conclude that a productivity offset should be applied to cable.

Respectfully submitted,

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REGULATORY PARITY AND PUBLIC POLICY

Prepared for

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by

Daniel Kelley and Robert Mercer

Hatfield Associates, Inc.

September 14, 1993

REGULATORY PARITY AND PUBLIC POLICY[1]

Several local exchange carriers (LECs) have filed Comments asking the Commission to establish regulatory parity between themselves and cable television companies.[2] We have been asked by Time Warner Entertainment Company, L.P. to provide an analysis of the regulatory parity issue. The statements of Robert L. Townsend and Richard D. Emmerson filed on behalf of Bell Atlantic, the NYNEX Telephone Companies and the Pacific Companies provide the most extensive discussion of the issues. Therefore, we will focus on those statements.

I. SUMMARY AND CONCLUSIONS

Dr. Emmerson argues that the cable television and telephone industries should be regulated identically in order to promote economic efficiency. The opposite is true. Regulated telephone services and regulated cable services are provided in quite different market circumstances. Given the dramatically different demand and supply situations in the two industries, there is no valid efficiency justification for increasing regulatory burdens on cable television companies in order to establish "regulatory parity."

Dr. Emmerson believes that LECs should be less regulated than they are today. But either inappropriate regulation of cable television companies or inappropriate deregulation of LEC services will actually reduce the long term prospects for competition. Inadequate regulatory safeguards will allow LECs to behave anticompetitively. Inappropriately strict

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[1] Daniel Kelley has filed statements in earlier stages of this proceeding. Robert Mercer's resume is attached.

[2] See the Comments of GTE, Comments of BellSouth and Joint Comments of Bell Atlantic, the NYNEX Telephone Companies, and the Pacific Companies.

regulation of cable companies will reduce their ability to become viable local exchange competitors.[3]

Mr. Townsend addresses the issue of cable industry productivity. He argues that the price cap formula that will be used to adjust benchmark rates should contain a productivity offset that matches the productivity offset in the LEC price cap formula. Mr. Townsend has produced no quantitative studies of productivity change in the cable business.[4] Even if historical studies had been produced, they would be of little relevance to future productivity trends in the cable television business.

Instead of providing measurements, Mr. Townsend provides an heuristic description of technological changes underway in the cable business, and then concludes that the factors driving productivity change in the local exchange and cable television businesses are similar. In fact, the two businesses start out with dramatically different system architectures and there is no basis for concluding that past or future productivity trends in the two industries are identical. Thus, there is no basis for concluding that productivity offset implicit in the Commission's existing price cap formula is inadequate.

Dr. Emmerson and Mr. Townsend fail to understand the regulatory scheme contained in the 1992 Cable Act and implemented by the Commission. For example, productivity increases being experienced by cable television programmers will be reflected in external

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[3] As discussed below, this may explain the involvement of some LECs in this proceeding.

[4] This is not a surprise, given the enormously difficult and time consuming task that generating reliable productivity data would require. See the Statement of Economists Incorporated filed with the Comments of the National Cable Television Association, and the Statement of David Roddy filed with the Comments of Continental Cablevision, Inc.

adjustments to the price cap. Yet Mr. Townsend argues that these productivity increases should contribute to an offset to the price cap adjustment. He also makes much of productivity increases for services that are not regulated.

The primary means by which cable television companies will be regulated is through the Commission's benchmark formula. If benchmark regulation is implemented correctly, rate of return regulation should be the limited exception in the industry. This makes much of Dr. Emmerson's discussion of the incentives that cable operators would face under rate of return regulation irrelevant. Moreover, as the Commission recently noted, Congress specifically ruled out common carrier regulation for the cable industry.[5]

Productivity issues are discussed in Section II. Section III addresses the incentives created by rate of return regulation.

II. THERE IS NO BASIS FOR A CABLE INDUSTRY PRODUCTIVITY OFFSET

Mr. Townsend's characterization of cable television technology is incorrect. Therefore, his declaration casts little or no light on the three primary technical and economic issues at stake in this proceeding, namely:

- What is the historical pattern of productivity change in the cable industry?
- Can historical productivity trends be projected into the future?
- Is there any correlation between cable system and LEC productivity, and, more cogently, between the respective <u>changes</u> in their productivity?

These issues are discussed below.

[5] See <u>First Order on Reconsideration, Second Report and Order, and Third Notice of Proposed Rulemaking</u>, released August 27, 1993, at para. 90.